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Summary

¶1. (U) Macroeconomic conditions of relatively low inflation and double-digit income growth have fueled another year of strong growth in Russia's banking sector. Consumer appetites boosted aggregate assets, and increasing confidence in the sector's stability raised retail deposits. Moreover, foreign capital participation exhibited considerable gains on the minority-, majority-, and wholly-owned fronts. On the regulatory side, the assassination of Central Bank First Deputy Chairman Andrey Kozlov sparked a national debate on how to continue strengthening bank supervision in particular and market oversight in general. The Central Bank (CBR) crafted new lending guidelines in defense of borrowers. Lenders will be required to disclose formerly "hidden" fees and commissions that had the effect of tripling or quadrupling the annual percentage rate on consumer loans. President Putin called on banks to enhance individuals' financial literacy and to extend more credit to the country's small and medium enterprises (SMEs). Nevertheless, assets remain highly concentrated as well as geographically centralized; the state continues to play a dominant, albeit shrinking, role in the sector; and the transparency of financial statements is lacking. This message supplements banking sector analysis that post's Economic Section will distribute via email to its Economic Weekly audience. End Summary.

2006: Another Year of Growth...

¶2. (U) Banks tapped into last year's favorable environment of single-digit inflation and swelling real disposable incomes (10 percent higher for the second year in a row) to continue spurring the boom in consumer goods. As banks competed for market share, aggregate assets grew more than six times faster than the overall economy and deposits rose more than five times faster than GDP. Loan values climbed 40 percent, and consumer lending expanded more than 75 percent during the year. Assets, however, remain concentrated, with the top five banks, four of which are state-controlled, holding more than 40 percent of total assets. More than half of the country's 1,189 credit institutions are registered in the city of Moscow and Moscow region. The regions, however, captured more than half of total banking sector assets by the end of 2006. Russia is on target to meet the National Banking Strategy's goal of an assets-to-GDP ratio of 60 percent by 2009.

...With Room to Grow

¶3. (U) Although increased consumer confidence boosted retail deposits almost 38 percent, the banking sector's financial intermediary potential was the focus of President Putin's November 2006 address to the State Council (Reftel A). He called on banks not only to educate existing and prospective clients on savings and borrowing programs but also to offer a wider variety of loans to SMEs. Putin supplemented the latter with proposed tax changes intended, among other things, to bring SMEs increasingly out of the grey economy. These changes would also facilitate more transparent accounting records and expanded access to credit financing. As a follow-up to the State Council address, the Finance Ministry is also developing a targeted federal project with the Ministry of Economic Development and Trade to make basic financial literacy programs available in educational, professional and social institutions.

¶4. (U) Mortgages enjoyed increased popularity during the year, growing fourfold to approximately USD 13.5 billion. Despite this dramatic rise, our banking and real estate contacts insist that mortgages finance only a small percentage of all housing sales. Loan processing times, which include buying life insurance, in conjunction with registration requirements associated with transferring ownership often mean that prospective mortgage borrowers cannot provide needed funds to sellers as quickly as buyers paying with cash.

GOR Reducing Share in Sector

¶5. (U) Sberbank conducted its secondary public offering (SPO) during 1Q07, a critical step in the process to reduce the government's participation in the banking sector. The CBR's holdings dropped to just over 60 percent of Sberbank's common shares. State-controlled Vneshtorgbank (VTB) will conduct an IPO soon to place just under 25 percent of its capital in private sector hands. The stated objective of these share placements is to increase each bank's lending capacity. The move will also increase competition among lenders, helping to achieve the plans of some of Russia's economic modernizers to sustain long-term growth.

Regulatory Changes

¶6. (C) In the aftermath of the September 2006 murder of CBR First Deputy Chairman Andrey Kozlov, President Putin restated his commitment to implementing the reforms Kozlov had championed to clean up the banking sector. Duma deputies, banking association leaders, and government officials have contributed to the nationwide debate on the best means of achieving Kozlov's goal of strengthening the hand of the regulator and ridding the country's financial markets of shadow economy participants. At the heart of this debate are allegations the CBR has been lax in its bank supervision responsibilities. The main recommendations for continuing Kozlov's reforms, ironically, center on removing the banking supervision function from the CBR and relocating thatQauthority within a unified financial markets regulator. CBR officials, however, have expressed confidence that the Central Bank will retain its bank supervision responsibilities. (Reftel B.)

¶7. (U) This debate notwithstanding, the Central Bank continued to work during the year toward achieving greater transparency in the banking sector. On behalf of prospective borrowers, First Deputy Chairman Gennady Melikyan drafted new rules requiring lenders to disclose all fees and commissions that comprise lending agreements. Hidden charges raised the annual percentage rate on consumer loans as much as four times the advertized rate. In an effort to enhance the reliability of banks' financial statements, for the third year in a row, the CBR is paying for its employees and banking sector accountants to become familiar with international financial reporting standards (IFRS).

Comment

¶8. (C) The banking sector continues to make incremental progress toward fulfilling its financial intermediary role. Middle class indicators are on the rise, as evidenced by growth in retail deposits, credit card usage, as well as mortgage and automobile financing. As this maturation process continued to unfold during the year, public and private sector observers began to question whether existing regulatory structures were adequate to manage the growth they hope the future will bring. Sector analysts and officials began actively considering modifications to current banking supervision roles and responsibilities for managing heightened competition among lenders, mitigating the effects of an upswing in non-performing loans while ensuring full compliance with anti-money laundering governance. Regardless of the outcome of the current debate, regulators will continue to face the dual challenge of spurring further development in the sector while enabling it to weather financial storms.

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